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CORPORATE INCOME TAXATION AND INEQUALITY: REVIEW AND DISCUSSION OF ISSUES RAISED IN *THE TRIUMPH OF INJUSTICE— HOW THE RICH DODGE TAXES AND HOW TO MAKE THEM PAY* (2019)☆

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This article surveys the literature on the relationship between corporate income taxation and inequality through the lens of the recent book *The triumph of injustice—How the rich dodge taxes and how to make them pay* by Saez and Zucman (2019). First, we analyze the nexus between corporate taxation and inequality by reviewing both studies that highlight the curbing effect of corporate tax on inequality, and by examining studies claiming that more corporate taxation might paradoxically raise personal inequality. Then we proceed by identifying current practices in taxing multinational entities, and provide an overview of the latest estimates on nations' missing fiscal revenues. Finally, we discuss the policy proposals put forward by Saez and Zucman (2019) to reform corporate taxation at the global level through the introduction of a global corporate minimum tax.

JEL Codes: D31, H24, H26, K34

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1. INTRODUCTION

This review article surveys the economics literature on the relationship between corporate income taxation and its effects on inequality through the lens of the recently published book *The triumph of injustice—How the rich dodge taxes and how to make them pay* by Saez and Zucman (2019). First, we recall one of the main theses of Saez and Zucman (2019): the overall degree of progressivity of the US tax system has declined steadily over the last decades due to, among other factors, a diminished effort to tax corporate profits and, more generally, income from capital.¹ The authors' claim is graphically supported by plotting the average tax rates

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¹In a recent book review of *The triumph of justice...*, Wolff (2020) highlights how the topic of redistribution in government intervention in the US should instead be analyzed by also examining the government expenditure side (the so-called *benefit principle*), rather than only focusing on the tax side as done in Saez and Zucman (2019) where the more traditional *ability-to-pay principle* is applied.

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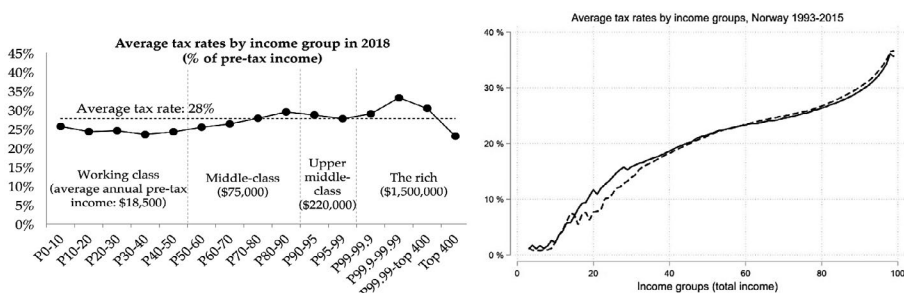


Figure 1. Average tax rates by income groups, US (left) vs Norway (right). *Note:* The above figures present a comparison of the average tax rates by income groups for the US and Norway. On the left, we plot the average tax rates by income group in the US in 2018 as presented in Saez and Zucman (2019), Figure 1.2 page 15, including individual income, property, corporate, consumption and payroll taxes. On the right, we compute the average tax rates by income group (considering total personal income) in Norway for two separate years, 1993 and 2015. Administrative data on total personal income (including pensions and transfers) and taxes (including individual income taxes, wealth taxes and social contributions paid to municipalities, regions and the state) are retrieved from microdata.no, an online portal administered by Statistics Norway.

by income group in 2018 (including individual income, property, corporate, consumption and payroll taxes), showing that the tax rate for the richest 400 individuals turns out to be lower than that levied on the working, middle, and upper-middle classes in 2018.

How can we qualify this claim? For the sake of comparison, we put the authors' estimation on the US tax system in perspective by showing, in Figure 1, our estimates of the average tax rates by income groups in Norway for both 1993 (solid line) and 2015 (dashed line). Notice that we only take into consideration individual income taxes, wealth taxes, and social contributions paid by employees here, hence abstracting from payroll and indirect consumption taxes which would make the curve flatter in Norway as well. Figure 1 highlights that the US tax system implies *higher* average tax rates for the bottom 90 percent than the Norwegian system, while it allows the top 10 percent to pay a *lower* share of income that they would have in Norway. Overall, and without employing more sophisticated measures (for a classical survey on measures of progressivity, see Lambert, 1985 or Kakwani, 1977), the rather low degree of progressivity of the US tax system appears indisputable.²

What lies behind the evidence of low progressivity of the US tax system? Saez and Zucman (2019) point to the slow agony of the corporate income tax. In the US, the statutory tax rate on corporate profits was between 48 percent and 52 percent from 1951 to 1978, with corporate tax liabilities representing the largest fraction of taxes that the top 0.1 percent of income earners were paying to tax authorities (Figure 2.3 on page 43 of Saez and Zucman, 2019). Since the early 1980s, the decline in the marginal tax rates on corporate income determined a paradigm shift: federal tax revenues from corporate income tax started to depart from

²See Tarroux (2019) for survey experiments that investigate how people value tax progressivity.

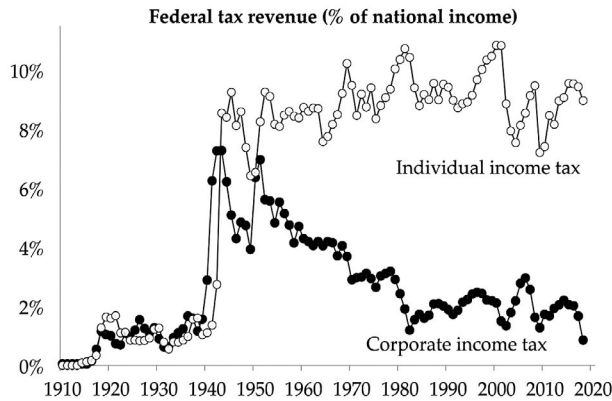


Figure 2. The slow agony of US federal revenues from corporate taxation. *Note:* Figure 4.1 page 70 in Saez and Zucman (2019), showing federal corporate and individual income tax revenue, percentage of national income.

the increasing revenues deriving from individual income tax, as shown in Figure 2 borrowed from Saez and Zucman (2019).

Departing from the above context that highlights the role of corporate income taxation for the progressivity of the tax system, in section 2 we review the inequality effects of the corporate income tax. Section 3 investigates the current practices of corporate income taxation for multinational entities, including the ongoing debate regarding alternative international tax architectures. Section 4 presents the proposals for reforming corporate and personal taxation put forward in Saez and Zucman (2019).

2. INEQUALITY EFFECTS OF CORPORATE TAXATION

In this section, we briefly survey the literature explaining the multifaceted and complex relationship between corporate income taxation and personal inequality. For the literature devoted instead to the relationship between capital taxation and inequality, refer to the survey by Bastani and Waldenström (2020). Since corporations' shareholders tend to overlap with individuals in the upper end of the income and wealth distributions, taxing corporations can be, at first sight, considered a handy tool to curb the degree of personal inequality. In fact, corporate tax changes might directly compress the distribution of post-tax disposable income, especially at the very top. Along these lines, Nallareddy *et al.* (2018) attempt to directly estimate the causal effect of US states' corporate tax cuts on top income inequality. By exploiting state-level inequality data, the authors find that that a 1 percent cut in corporate taxes raises the share of income accruing to the top 1 percent by 0.9. Regarding the mechanism behind this causal evidence, the authors suggest that this result is largely due to top earners shifting income from labor to capital income in response to corporate tax cuts in order to reduce their overall tax liabilities. This result highlights that corporate taxation qualifies as a necessary element for a coherent tax system since its presence makes it less attractive to shift income

from the personal tax base to the corporate tax base (Bastani and Waldenström, 2020). Graham (1936) is, to the best of our knowledge, among the first studies to investigate in depth the functioning of the undistributed profits tax. He highlights that such a tax would induce corporations to distribute a higher share of retained earnings to shareholders, which will then be subject to progressive personal income taxation. Graham (1936) adds (page 10) that “the Undistributed Profits Tax will lead to undistributed cash disbursements by companies [...], and to the issuance of additional stock generally to represent reinvested earnings. As far as those particular effects are concerned, we consider them favorable to the stockholders and not inimical to the financial soundness of corporations.” Hager and Baines (2020) highlight how a gradual reduction in corporate taxation in the US has led to increasing power for large corporations in the corporate sector, causing stronger corporate concentration. By their nature, large corporations tend to focus more on shareholder value enhancements that directly benefit the asset-rich, rather than on productivity-enhancing investments that could benefit working-class employees, resulting in wider household inequality.

Caution is, however, recommended due to the indirect behavioral effects of corporate taxation. Corporate taxation influences the demand for capital and labor and ultimately the return to capital, hence the general effects on inequality are not straightforward and require investigating the economic incidence of taxes. Following Musgrave and Musgrave (1984), the process of *shifting the tax burden* might lead to a final distribution of income substantially different from that hypothesized by simply looking at *statutory* incidence. Higher corporate taxes might lower demand for capital and hence reduce the capital stock, increasing its return and thereby widening the income distribution. Higher corporate taxes might also result in higher prices from manufacturing corporations, hence shifting the burden to consumers (Ablett and Hart, 2005). Arulampalam *et al.* (2012) and Fuest *et al.* (2018) analyze the extent to which taxes on corporate income are passed on to wages, and find that workers bear about one-half of the total tax burden. Clausing (2013)’s review of the empirical work in this specific area shows that the empirical evidence of adverse effects on labor contains several pitfalls related to the robustness of results. For a recent analysis on the incidence of US states’ corporate taxes on the welfare of workers, landowners, and firm owners, see Suárez Serrato and Zidar (2016).

There are also studies pointing out that more corporate taxation might paradoxically raise personal inequality. Hines (2020) claims that a collateral effect of taxing corporations might be that owners relocate their firms abroad or into the non-corporate sector, with the latter exhibiting a higher dispersion of capital income than in the corporate universe. In other words, Hines (2020) builds on Harberger (1962) to claim that the main effect of an increase in the corporate tax is rather to shrink the corporate sector, leading several business owners to shift to the non-corporate sector, a sort of *reallocation* effect. An increasing share of non-corporate businesses in the economy raises the level of idiosyncratic risk (due to less diversification), thereby widening the distribution of income.

3. CORPORATE TAXATION AND MULTINATIONALS

To understand the linkage between corporate taxation and inequality in a deeper way, current corporate taxation practices and strategies by multinationals are next described. Corporate taxation is a key component of the fiscal system of both developed and developing countries.³ Its main role is to act as a backstop to personal income taxation, a sort of withholding device for the personal income tax. The corporate income tax also ensures that foreign owners of domestic corporations pay taxes in the host country. However, the ability of sovereign jurisdictions to raise revenue through corporation taxes is limited by the current international tax rules based on the separate entity and *arm's length* principle. Such rules facilitate tax avoidance by multinational enterprises through the shifting of profits abroad. This, in turn, reduces the local corporate tax base (Huizinga and Laeven, 2008). For tax purposes, under the arm's length principle, a multinational corporate group should price transactions with its related entities (i.e., those that are ultimately owned by the same shareholders) as if those transactions had occurred with unrelated entities.

Multinationals are required to identify market-based prices for the transfer of goods and services *within* the multinational in order to obtain a price that approximates the result that independent entities would reach in the market. There are numerous ways to determine the arm's length price, and the flexibility embedded in these rules allows firms to choose transfer pricing methodologies that support the use of internal prices, shifting profits from high- to low-tax countries. Transfer prices are, therefore, likely influenced by the tax-minimization strategies of multinational firms. Also there is a strong and statistically significant relationship between countries' tax rates and the prices of intrafirm transactions (Bartelsman and Beetsma, 2003; Clausing, 2003). Thus, multinationals can shift profits from high- to low-tax countries through intragroup financing (Faccio and FitzGerald, 2018) and trade in goods and services (Bartelsman and Beetsma, 2003; Cristea and Nguyen, 2016; Wier, 2020), thereby reducing the corporate tax base.

The rise of intellectual property as a share of multinationals' value, in addition to its high mobility, has enabled multinationals to locate their ownership in jurisdictions that provide preferential tax treatment and to structure intragroup transactions to shift profits arising from the exploitation of intellectual property to low-tax jurisdictions. Griffith *et al.* (2014) show that multinationals' decisions over where to locate the legal ownership of their patents are affected by corporate tax rates and preferential tax treatment in relation to the exploitation of intellectual property. Overall, the current system creates incentives for multinational companies to manipulate the apparent location of profit towards low-tax jurisdictions (Auerbach *et al.*, 2008).

Alternative international tax architectures to those described above are widely discussed in the literature. These alternatives require treating multinationals as unitary businesses and replacing the separate entity principle. Under residence-based worldwide taxation (Peroni *et al.*, 2009), the home country of a multinational

³An overview of Corporate Tax Statistics from the OECD can be found here: <https://www.oecd.org/tax/tax-policy/corporate-tax-statistics-second-edition.pdf>.

applies the domestic tax scheme directly on the consolidated worldwide profits of a corporate group (with full credit for foreign taxes paid). This approach would allow all profits to be taxed, as a minimum, at the rate of the home country of the multinational, regardless of intragroup transfer pricing.

Unitary solutions can also shift taxing rights to jurisdictions in which the purchaser is located. One such solution is the destination-based cash flow tax (DBCFT) (Auerbach, 2017; Auerbach *et al.*, 2017; Auerbach and Devereux, 2018; Hebous *et al.*, 2020); this is equivalent to a broad-based, single-rate VAT combined with a wage subsidy at the same rate. The DBCFT is considered to improve economic efficiency by taxing corporate profits in a relatively immobile location (the location of final purchasers of goods and services), and to be robust against tax-avoidance structures. However, applying the DBCFT with a *border tax adjustment* (i.e., allowing the deduction of domestic but not foreign costs) would likely be regarded as trade distorting and hence would potentially conflict with WTO rules (Cui, 2017).

Under *formulary apportionment*, global profits of a multinational are consolidated to generate a unitary base that is apportioned between jurisdictions through the use of a formula. Formulary apportionment currently exists at the subnational level in the USA, Germany, Canada, and Switzerland. The unitary base is apportioned across states (or provinces or cantons) using different, agreed-upon formulas and weights. The choice of formula naturally has implications for the distribution of taxing rights between countries and revenue generation (Clausing and Lahav, 2011; Pethig and Wagener, 2007; Riedel, 2018; Shackelford and Slemrod, 1998), but this system could also eliminate opportunities to shift profits to low-tax jurisdictions through intragroup transfer pricing.

The European Commission has proposed a “Common Consolidated Corporate Tax Base” (CCCTB) for the EU,⁴ where a uniform common tax base is established across member states. This tax base is then apportioned across member states by three equally weighted factors: sales, tangible fixed assets, and labor (payroll and numbers of employees). Worldwide formula apportionment has also been proposed, with the reallocation of global profits based on sales (Avi-Yonah and Clausing, 2011) or through the use of a more balanced formula⁵ (Picciotto, 2018).

A bridging solution combining elements of formula apportionment and the conventional arm’s length principle is residual profit allocation (Avi-Yonah *et al.*, 2009), under which routine profits are allocated to jurisdictions on the basis of the function or activity performed, while residual profits are allocated (to some degree, if not wholly) on some formulaic basis.

To address the issue of tax avoidance of multinationals, in 2013, the G20 called on the OECD to coordinate efforts to reform the international corporate tax system through the Base Erosion and Profit Shifting (BEPS) initiative (Dharmapala, 2014). This political negotiation is ongoing within the G20-OECD Inclusive Framework,⁶ with an outcome expected by mid-2021. The solutions currently

⁴See Common Consolidated Corporate Tax Base (CCCTB).

⁵See ICRIT—The Independent Commission for the Reform of International Corporate Taxation: A road-map to improve rules for taxing multinationals.

⁶See Base erosion and profit shifting (BEPS).

being negotiated include, for the first time, the treatment of multinationals as unitary businesses and the allocation of a portion of residual profit of in-scope businesses to market/user jurisdictions, as well as a global minimum tax that would provide jurisdictions with a right to “tax back” where other jurisdictions have not exercised their primary taxing rights.⁷

As pointed out above, corporate taxation reforms at the national level are hampered by profit shifting to foreign countries and loss of fiscal revenues. These in turn heavily limit the efficacy of re-distributional government policies and widen the post-tax distribution of income (Gravelle, 2009). How large is the phenomenon of tax avoidance through corporate profit shifting?

Exactly estimating the scale of corporate profit shifting and associated revenue losses is difficult due to the lack of available public data. No estimate is definitive, but all available estimates are indeed of practical value for policymakers. Cobham and Janský (2018) estimate a yearly global revenue loss of approximately USD 500 billion. In a subsequent study, Janský and Palanský (2019) compare estimated corporate tax revenue losses for groups of countries (grouped by GDP and volume of tax revenues), concluding that there are almost no statistically significant differences across country groups. Crivelli *et al.* (2016) estimate USD 600 billion of yearly global revenue losses, divided into USD 400 billion of losses in OECD countries (equivalent to 1 percent of GDP), and USD 200 billion in non-OECD countries (equivalent to 1.3 percent of GDP). Torslov *et al.* (2020) estimate that up to 40 percent of US multinationals’ overseas profits are shifted to low-tax jurisdictions each year, leading to global revenue losses of USD 200 billion, in line with OECD’s estimates of global losses in between USD 100–240 billion (OECD, 2015).

Discrepancy in the estimates just noted can be attributed first to a missing agreed upon methodology regarding how to estimate tax avoidance by multinationals, and second to the fact that public data are not yet available with respect to profits and taxes paid by multinationals in each of the countries in which they operate. However, progress has been made since the eruption of the financial crisis in 2007, as multinationals with a global turnover of above USD 750 million now have to annually report to their jurisdictions of residence via a country-by-country (CbC) report, which includes information on revenue, sales, profits before tax, and tax paid in each of the jurisdictions in which the multinationals operate. These data can subsequently be shared among tax authorities. In fact, the first actual exchanges took place in 2018. As of January 2020, 57 states have been exchanging CbC reports, while 90 jurisdictions have legislation in place to introduce a CbC reporting obligation. Summary data for a number of selected countries were published for the first time in 2020 by the OECD.⁸ The United States published consolidated data of country-by-country reports for the years 2016 and 2017.

Notwithstanding the intrinsic limitations of CbC reporting,⁹ these data are informative as they indicate that a large share of US multinationals’ profits are shifted to low-tax jurisdictions (e.g., Cayman Islands). For 2017, the data shows

⁷See Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two.

⁸See Action 13 Country-by-Country Reporting.

⁹See Limitations of the CbC reporting.

that out of USD 4.2 trillion in accumulated foreign profits of US multinationals subject to country by country reporting disclosure requirements, 3 trillion dollars are recorded in low tax jurisdictions. In 2017, just 11 low tax jurisdictions accounted for 56 percent of US MNE foreign profits.¹⁰ This shift resulted in a misalignment in the distribution of profits relative to economic activity (Desai *et al.*, 2006).

4. POLICY PROPOSALS TO REFORM THE TAX SYSTEM

The relationship of tax avoidance by multinationals and the relationship to personal income inequality, the focus of this review article, begs for policy proposals which Saez and Zucman (2019) provide. The issue of offshore tax evasion poses an enormous challenge to the efficacy of tax systems in curbing the degree of inequality (Alstadsæter *et al.*, 2018, 2019; Dharmapala, 2008; Zucman, 2013, 2014). Alstadsæter *et al.* (2019) show that offshore tax evasion is highly concentrated among the rich, indicating that official inequality estimates are potentially highly underestimated when not properly accounting for unreported assets. The proposals that we focus on are corporate-taxation specific; however we also briefly introduce the Saez and Zucman proposed reforms for personal taxation.

Two complementary solutions are proposed to limit tax competition between jurisdictions and ensure consistent global minimum taxation of corporate profits. The first solution is to introduce a global effective *minimum* corporate tax, which would ideally ensure that profits from multinationals are taxed at a minimum rate of 25 percent regardless of the location of the affiliate. According to Saez and Zucman (2019), if G20 countries were to introduce such a rule, 90 percent of the world's corporate profits would be effectively taxed at 25 percent or more, de facto curbing the global volume of profit shifting. The second complementary solution can be considered a defensive measure against multinationals headquartered in countries that refuse to cooperate and do not introduce the minimum tax rule. Any government implementing a global minimum corporate tax would also calculate the tax *deficit* of multinationals, that is, the extra tax that a multinational would pay if it were subject to an effective tax rate of 25 percent in each of the countries in which it operates (see Clausing *et al.*, 2020 for details on the design of this solution). Any country implementing this defensive measure will then become a tax collector of last resort, which would ensure that the global minimum tax is upheld. Without this complementary defensive measure, multinationals' inversion (i.e., switching corporate residency) would enable them to elude taxation, although US anti-inversion rules and the 2016 EU Anti-avoidance directive¹¹ have made these inversions more costly.

The idea of a global minimum tax rate builds on the current US global intangible low-taxed income (GILTI) rule,¹² which applies a minimum tax of 10.5 percent to US multi-nationals' foreign affiliates' income deriving from the exploitation of intangible assets. The proposal of the corporate minimum tax rate is similar to the proposal currently being negotiated within the G20-OECD Inclusive

¹⁰See 5 Lessons on Profit Shifting From US Country-by-Country Data.

¹¹See The Anti-Tax Avoidance Directive.

¹²See IRS and Treasury issue guidance related to global intangible low-taxed income (GILTI).

Framework. However, Saez and Zucman (2019)'s proposal is much more comprehensive than the US GILTI rule and what is currently being negotiated by the G20-OECD. This is because their minimum tax proposal is intended to apply on *all* profits of overseas affiliates, on a country basis and with no carve-outs/exemptions, as opposed to the US GILTI rule, which uses a global blending approach for determining profits subject to the minimum tax.

As regards personal taxation, Saez and Zucman (2019) propose to integrate corporate and individual taxes to make corporate tax shelters meaningless and curb the degree of personal income and wealth inequality. In this system, corporate taxation is only a prepayment for the individual income tax. Regarding tax rates, they envisage a top marginal tax rate of 75 percent on all income earned above the threshold of USD 500000, implying an average tax rate of 60 percent for the 1 percent richest Americans. To reach this target, the three necessary elements are: a progressive income tax, a corporate tax, and A progressive wealth tax (currently the only element not in place). The latter is considered by the authors as an important instrument to raise the overall degree of tax progressivity in the US, which cannot be attained by the income and corporate tax alone. In addition, Saez and Zucman (2019) advocate the introduction of a national income tax (a flat tax, with a single rate of 6 percent on both labor and capital incomes) to sustain large government expenditures, such as universal social insurance programs, health care and education for all. In his review of this book, Weber (2020) claims that the authors do not elucidate on the different effects of the national tax proposal, regarding its administration, legal challenges that could arise or potential behavioral effects.

5. CONCLUDING REMARKS

This review article covers the literature on the multifaceted relationship between corporate income taxation and inequality in light of a set of debates opened by Saez and Zucman (2019). First, we analyzed the complex relationship between corporate taxation and inequality, identifying both contributions that highlight the curbing effect of corporate tax on inequality, and those that claim that corporate taxation might paradoxically raise personal inequality. We proceeded by identifying the current practices of taxing multinational entities and potential alternatives under discussion, and we provided an overview of the latest estimates on the missing fiscal revenues of nations. Finally, we discussed the policy proposals put forward by Saez and Zucman (2019) to reform corporate taxation at the global level, namely, the introduction of a corporate minimum tax and its functioning.

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